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12 SUPERIOR COURT OF STATE OF ARIZONA
13 COUNTY OF YAVAPAI

14 STATE OF ARIZONA,

15 Plaintiff,

16 vs.

17 JAMES ARTHUR RAY,

18 Defendant.
19
20
21

CASE NO. V1300CR201080049

Hon. Warren Darrow

DIVISION PTB

**DEFENDANT JAMES ARTHUR RAY'S
BENCH MEMORANDUM RE: ANGEL
VALLEY'S UNRELATED BUSINESS
TAXABLE INCOME**

22 Defendant James Arthur Ray, by and through undersigned counsel, hereby files the
23 attached Bench Memorandum regarding Angel Valley's Unrelated Business Taxable Income.
24 This Memorandum demonstrates that Mr. Ray has a good faith basis to ask on cross examination
25 questions related to Angel Valley's tax status and whether it pays taxes on profits generated by its
26 commercial activities, and that such testimony is relevant and admissible.
27
28

MEMORANDUM OF POINTS AND AUTHORITIES

I. INTRODUCTION

It is undisputed that Angel Valley charged the 2009 Spiritual Warrior Seminar participants approximately \$107,000 for room and board and charged similar amounts for Spiritual Warrior Seminars in prior years. Angel Valley holds itself out as a 501(c)(3) tax-exempt organization. See <http://www.angelvalley.org/pages/aboutus/philosophy-vision-mission.html>.

II. LEGAL STANDARD

A. Unrelated Business Income is Taxable

Various tax-exempt entities, including certain religious entities described in IRC Section 501(c)(3), are generally exempt from U.S. federal income taxation. IRC Section 501(a). Notwithstanding that general exemption, tax is imposed on the “unrelated business taxable income” (UBTI) of such entities. IRC Section 511. As outlined below, Angel Valley’s activities in connection with its practices of charging room and board to third-party retreats (including the JRI retreat in 2009) raise legitimate questions regarding its generation of UBTI and its payment of the taxes required to be paid in connection therewith.

UBTI is defined as the gross income derived by an organization from any “unrelated trade or business . . . regularly carried on by it,” less the deductions directly related to the carrying on of such trade or business. IRC Section 512(a)(1). An “unrelated trade or business” is any trade or business the conduct of which is not “substantially related” to the exercise or performance by a tax-exempt organization of its exempt purpose or function. For that purpose, the required substantial relationship cannot be based on the organization’s need for income or funds or the use it makes of the profits derived from the activity. IRC Section 513(a). Rather, the determination of whether income derives from an unrelated trade or business requires an examination of the relationship between the actual business activities that generate the income and the accomplishment of the organization’s exempt purpose. Business activities are substantially related to an exempt purpose only where the conduct of the business activities has a substantial causal relationship to the achievement of the exempt purpose (other than through the production of income). Treasury Regulation Section 1.513-1(d).

1 Thus, for example, income derived by a tax-exempt hospital from the regular performance
2 of diagnostic laboratory testing for non-patients is generally treated as UBTI, even where the
3 hospital's income from the performance of the same services for its own patients is not. For
4 similar reasons, Angel Valley's provision of lodging, meals and other goods and services through
5 its operation of a retreat center for third parties are not substantially related to its own religious
6 purpose (so that any income derived from the regular conduct of that activity would be subject to
7 treatment as UBTI).

8 A trade or business is generally treated as "regularly carried on" if the activities manifest a
9 frequency and continuity, and are pursued in a manner generally similar to the commercial
10 activities of non-exempt organizations. Treasury Regulation Section 1.513-1(c). For example,
11 while income from a tax-exempt organization's annual fundraising event would ordinarily not be
12 treated as income from a trade or business that is regularly carried on (and, consequently, would
13 not be treated as UBTI), income from an activity that is not merely casual, but is systematically
14 and consistently promoted and carried on by the organization ordinarily would be (*e.g.*, the
15 operation of a commercial parking lot each Saturday). Again, Angel Valley's regular rental of its
16 retreat facilities to third parties would appear to qualify as UBTI.

17 Certain types of income, including most types of passive investment income, are excluded
18 from UBTI. Although rents from real property are also generally excluded, that exclusion is
19 narrowly tailored. IRC Section 512(b)(3). Indeed, payments for the use or occupancy of rooms
20 and other space where services are also rendered to the occupant, such as for the use or
21 occupancy of rooms in hotels, boarding houses or tourist camps, do not qualify as rents from real
22 property. Generally, services such as maid service are considered as rendered to the occupant and
23 give rise to UBTI, whereas services such as the furnishing of heat and light do not. Treasury
24 Regulations Section 1.512(b)-1(c)(5). Since Angel Valley rents its retreat facilities to third
25 parties on a short-term basis and provides dining and other services in connection with the rental
26 activity, the exclusion from UBTI would not appear to apply and the income generated is taxable.

1 Finally, income from certain debt-financed property can be subject to UBTI without
2 regard to whether the property is used in a trade or business or would otherwise qualify for an
3 exclusion. IRC Section 514. Generally, debt-financed property is any property held to produce
4 income on which there is acquisition indebtedness. Acquisition indebtedness includes debt
5 incurred to acquire or improve the property or, in many cases, debt that would not have been
6 incurred but for the acquisition or improvement of the property. Thus, if the retreat center is
7 subject to debt or if Angel Valley otherwise has loans or other indebtedness outstanding, some or
8 all of its income from the retreat center may constitute UBTI even if such income would not
9 constitute UBTI in the absence of any debt financing.

10 **B. Angel Valley Has Not Filed Form 990 Tax Returns Declaring UBTI**

11 Tax-exempt entities described in IRC Section 501(c) are generally required to file Form
12 990-T with the IRS if they have gross income from an unrelated trade or business of \$1,000 or
13 more for any taxable year. Treasury Regulations Section 1.6012-2(e). The Form 990-T filing
14 requirement extends to churches, which are otherwise exempt from certain return filing
15 requirements applicable to some other tax-exempt entities. A tax-exempt entity's Form 990-T is
16 required to be made available to the public. Notice 2007-45. The attached screen shots from
17 Guidestar (a nonprofit that compiles information about nonprofit entities) indicate that the basis
18 of Angel Valley's tax exemption is religious (presumably under IRC Section 501(c)(3)), but there
19 is no indication that it has filed a Form 990-T with the IRS with respect to its business activities.
20 See Exhibit A.

21 **C. Inquiry into Angel Valley's Payment of Taxes is Relevant and Admissible**

22 Thus, it appears that Angel Valley generated substantial income by charging for room and
23 board to the participants of the 2009 Spiritual Warrior Seminar. The defense has a good faith
24 basis to believe that no taxes were paid on any of this income. Questioning in this area is likely to
25 elicit relevant and admissible testimony. At oral argument, the State erroneously stated that
26 questions in this area are improper under Rule 404(b). Instead, inquiry into these matters is
27 appropriate because it bears on the Hamiltons' credibility and is probative of the Hamiltons'
28 character for truthfulness, as permitted under Rule 608(b).

1 “Evidence impeaching a witness’s credibility is always relevant.” *E.g., Hernandez v.*
2 *State*, 201 Ariz. 336, 338 (App. 2001), vacated on other grounds, 203 Ariz. 196 (2002).
3 Accordingly, such evidence is admissible unless barred by another rule. No such bar applies
4 here. To the contrary, the failure to pay taxes is affirmatively admissible under Rule 608(b)
5 because it is probative of truthfulness or untruthfulness. As the Second Circuit has explained,
6 “[e]vidence that a witness has made false statements in a tax return is obviously a matter which
7 affects the witness’s credibility,” and “[t]he total failure to file tax returns” for years “should be
8 similarly admissible on the issue of her truthfulness, subject to the discretionary considerations in
9 Rules 403 and 608(b).” *Chnapkova v. Koh*, 985 F.2d 79, 82 (2d Cir. 1993) (cited in 1 Ariz. Prac.,
10 Law Of Evidence § 608:3 (Rev. 4th ed.)), *abrogated on other grounds, Jaffee v. Redmond*, 518
11 U.S. 1 (1996). Accordingly, the Second Circuit concluded that the plaintiff’s “failure to file tax
12 returns bore directly on her credibility,” and that the district court had abused its discretion by
13 excluding the testimony. *Id.* at 83. *See also Chamblee v. Harris & Harris, Inc.*, 154 F.Supp.2d
14 670, 681 (S.D.N.Y. 2001) (“Evidence that a witness has failed, for years, to file a tax return is a
15 matter which affects the witness’s credibility.”); *United States v. Bustamante*, 45 F.3d 933, 946
16 (5th Cir.1995) (defendant objected to testimony regarding his “failure to report or pay taxes on
17 certain income,” but the court held the evidence was “relevant to the issue of honesty” and
18 admissible under Rule 608(b)); *United States v. Hatchett*, 918 F.2d 631, 641 (6th Cir. 1990)
19 (witness’s “failure to pay taxes was clearly probative of his credibility”).

20 **III. CONCLUSION**

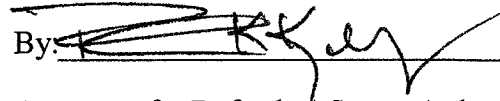
21 Well-established law provides that questions on cross examination require a good faith
22 basis, and that questioning is permissible where it addresses conduct probative of a witness’s
23 credibility or character for untruthfulness. Here, the defense seeks to question the Hamiltons
24 regarding their claimed tax-exempt status and their various commercial activities. The evidence
25 and law establish that: (1) Angel Valley charged \$107,000 for room and board at the 2009
26 Spiritual Warrior Seminar as well as similar amounts at other seminars in other years; (2) income
27 from such commercial activities (defined as Unrelated Business Taxable Income) is taxable; and
28 (3) Angel Valley does not appear to have filed tax returns reporting such income. Questions

1 regarding these topics are grounded in a good faith belief and are admissible under Rules 401,
2 402, and 608(b).

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4 DATED: April 19th, 2011

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11 Copy of the foregoing delivered this 19th day
12 of April, 2011, to:

13 Sheila Polk
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16 by M. Dingo


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Blog Address

Contact

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Category (NTEE)

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Ruling Year

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